October 31, 1991

COORDINATED ISSUE
COMMERCIAL BANKING
GROSS-UP NET LOANS (Renamed from - Foreign Withholding Taxes)

ISSUE

1) Whether an amount equal to the foreign withholding taxes paid by borrowers pursuant to "net" loan agreements must be included in gross income of the lender in the taxable year in which the obligation of the borrower to pay such taxes arose.

(2) If the foreign withholding tax is creditable and included in the income of the lender, whether such taxes recognized for purposes of inclusion in the lender's gross income are also considered documented for purposes of the foreign tax credit in accordance with Section 905 of the IRC.

(3) Whether the accrued income can be reduced by a deduction or otherwise to reflect a reduction in the corresponding amount of foreign tax credits allowed to the lender.

FACTS, LAW AND ARGUMENT

The bank, a domestic corporation, during the year under examination negotiated foreign loans on a net basis whereby any foreign taxes due thereon were to be paid and be the responsibility of the debtor. The type or form of the loan varies but the ultimate result is that the borrower pays the bank the full interest rate stated in the contract, not reduced by any foreign taxes. Any foreign taxes due are, under the loan agreement, the responsibility of the borrower.

Under the laws of the foreign countries of the borrowing companies, the bank is the "technical taxpayer" of the relevant taxes and has a liability to pay income tax on the amount of interest received with respect to such loans and that in the event of the failure of a borrower to pay such tax, the lender must pay the tax. Typically, the foreign borrower is obligated to submit to the lender documentation proving payment of the tax. Failure to provide such evidence is an event leading to default. The failure to submit documentation may reflect the fact that (1) the foreign borrower failed to discharge the lender's tax liability, (2) the borrower merely neglected to submit the documentation, or (3) there never was a foreign tax liability.

In a Technical Advice issued on March 22, 1979, concerning this issue, it was held that: (1) the lender is entitled to claim a foreign tax credit for the tax paid by a borrower pursuant to a "net" loan agreement under which interest is received by the lender without deduction for the tax; (2) the tax assumed by the borrower is includible in gross income of the lender as additional interest income in the taxable year in which the lender accrued its tax obligation; and (3) the tax, includible in the gross income of the lender as additional interest income, remains to be properly documented, in accordance with Section 905 of the Code and Section 1.905-2 of the Income Tax Regulations, because such documentation is independent of and not satisfied by the inclusion of additional income with respect to such tax. In addition, the Technical Advice, citing Acme Coal Co. v. United States, 44 F. 2d 95 (Ct. C1. 1970), provided in the rationale that if the amount of income accrued by the lender differs from the amount of the actual tax liability ultimately assumed and paid, an adjustment to income for the year of accrual is to be made.

In some instances, the lender has taken the position that one only has to include as additional income that amount that will match foreign taxes documented as paid for foreign tax credit purposes (the "paper" system). Initially, the lender only includes in its tax return for the year in which the foreign tax liability accrues such income amount and corresponding foreign tax credits that can be documented at that time. If it receives additional documentation for the foreign taxes in later years, on audit or by claim, the lender submits the additional documentation and claims additional income and credits for the earlier year in which the foreign tax liability is properly accrued.

Section 451(a) of the Code provides a general rule that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the regulations provides, in part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Section 461(a) of the code provides, in part, that the amount of any deduction or credit shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1(a)(2) of the regulations provides, in part, that under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

Section 166(a)(1) of the code allows a deduction for any debt that becomes worthless within the taxable year. Section 166(c) provides, in lieu of deduction under section

166(a), that there shall be allowed (in the discretion of the Secretary), a deduction for a reasonable addition to a reserve for bad debts.

Section 1.166-1(c) of the regulations provides that only a bona fide debt qualifies for purposes of sections 166 of the Code and defines a bona fide debt as a debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.

Section 1.166-2(a) of the regulations provides, in part, that in determining whether a debt is worthless in whole or in part the District Director will consider all pertinent evidence, including the financial condition of the debtor.

Section 1.166-2(d) of the regulations provides that if a bank, which is subject to supervision by federal authorities, charges off a debt in whole or in part in obedience to the specific orders of such authority, then the debt shall to the extent charged off and deducted for federal income tax purposes, be conclusively presumed to be worthless during the taxable year.

If one discharges the tax liability of another, the taxpayer who is liable for the tax realizes additional income. Old Colony Trust v. Commissioner, 279 U.S. 716 (1929). An accrual basis taxpayer must accrue additional income for taxes assumed by another at the time such taxes are properly accruable and the obligation is assumed, and not at a time in future when the assumed tax liability is ultimately satisfied. Rev. Rul. 57-106, 1957-1 C.B. 242, as modified by Rev. Rul. 78-258, 1978-1 C. B. 239; Commissioner v. Terre Haute Electric Co. 67 F. 2d 697 (7th cir. 1934). In accordance with the all events test section 1.461-1(a) of the regulations, an expense is deductible when all the events have occurred which determined the facts of the liability, and the amount of the liability can be determined with reasonable accuracy. With respect to the facts previously cited, the fact and the amount of the lender's liability for foreign taxes is known when the liability is fixed and the tax payment becomes due; generally this occurs when the interest is paid to the lender or, in some countries, when the interest payment is due. Therefore, the lender must accrued additional income at the time it assumed the foreign tax liability accruable by it under section 1.461-1(a) of the regulations (i.e. when then liability is fixed to pay the tax), and not when the liability is ultimately satisfied by the borrower. In addition, in order to receive a foreign tax credit for the accrued foreign taxes, the lender must submit proper documentation under section 905(b) of the Code and section 1.905-2 of the regulations. This documentation requirement is not satisfied by, and is independent of, the inclusion of additional income resulting from the borrower's assumption of the lender's foreign tax liability.

"When an income item is properly accrued and subsequently becomes uncollectible, a taxpayer's remedy is, by way, a deduction rather than through elimination of the accrual. Moreover, this rule is applicable even when the item is accrued and becomes uncollectible during the same taxable year." Rev. Rul. 80-361, 1980-2 C.B. 164, citing Spring City Foundry Co. v. Commissioner, 292 U. S. 182 (1934), 111-1 C. B. 28 (1934) and Atlantic Coast Line Railroad Co. v. Commissioner, 31 B.T.A. 730, 751, (1934) acq. XIV-2 C. B. (1935). Although the lender may not reverse a proper accrual of income, it may be entitled to a bad debt deduction under section 166 of the Code. The foreign borrower's contractual obligation to pay the lender's foreign tax liability is a bona fide debt which, if in default, would qualify for the deduction. (See section 1.166-1(c) of the regulations).

EXAMINER'S POSITION

(1) The lender must accrue additional income on "net" loans at the time foreign taxes assumed by borrowers would have been accruable by the lender as tax obligations pursuant to section 1.461-1(a) of the regulations and not when the liability is ultimately satisfied by the borrowers.

(2) Such additional income may not be adjusted by a reversal of income to reflect the amount of foreign taxes actually paid unless the initial accrual of income was not proper, but may take a deduction under Section 166 for the appropriate charge to its bad debt reserve to the extent the foreign borrower's failure to pay the foreign tax liability meets bad debt requirements of section 166 and the regulations thereunder.

(3) In order to receive a foreign tax credit for the accrued foreign taxes, the lender must submit proper documentation under IRC 905(b) and Section 1.905-2 of the Regulations.